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In the Supreme Court of the United States

October Term, 1993

FRANK L. BRYANT, KEMPER SECURITIES, INC., a Delaware Corporation (formerly known as BATEMAN EICHLER, HILL RICHARDS, INC.), CHARLES R. HEMBREE, and KINCAID, WILSON, SCHAEFFER & HEMBREE, P.S.C., a Kentucky Corporation,

PETITIONERS,

v.

CALVIN KLEIN, GEORGE E. LAYMAN, JR., GEORGE E. LAYMAN, ZENYA YOSHIDA, DBA SHADAI FARMS, KENNETH FRANZHEIM, II, BLAS R. CASARES, EARL H. SHULTZ, RICHARD L. SCHULTZ, VIRGINIA M. McGONIGLE, JOHN F. McGONIGLE, H. JAMES GRIGGS, BARRY K. SCHWARTZ, FOREST ACRES PARTNERSHIP, a Washington State General Partnership, BARRY K. SCHWARTZ PARTNERSHIP, a New York Partnership and ROBERT D. STRATMORE,

RESPONDENTS.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

THOMAS K. BOURKE*
DAVID L. ARONOFF
Turken, Melman & Bourke
A Law Corporation
9300 Wilshire Blvd., Ste. 555
Beverly Hills, CA 90212
(310) 859-7500

Attorneys for Petitioner Frank L. Bryant

***Counsel of Record**

JAMES E. BURNS, JR.
JOHN MISSING
KEVIN P. MUCK
Brobeck, Phleger & Harrison
One Market Plaza
San Francisco, CA 94105
(415) 442-0900

Attorneys for Petitioner Kemper Securities, Inc. (formerly known as Bateman Eichler, Hill Richards, Inc.)

M. LAURENCE POPOFSKY
MICHAEL L. RUGEN
RICHARD DeNATALE
Heller, Ehrman, White & McAuliffe
333 Bush St., Ste. 3100
San Francisco, CA 94104-2878
(415) 772-6000

Attorneys for Petitioners Charles R. Hembree and Kincaid, Wilson, Schaeffer & Hembree, P.S.C.

Westside Law Publishers • West Hollywood, California 90069 • (310) 273-2887

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QUESTIONS PRESENTED FOR REVIEW

1. Whether courts should enforce indemnity clauses in stock purchase agreements in which buyers agree to indemnify sellers for any losses, including attorneys' fees, arising from the untruth of any of the buyers' representations?

2. Whether courts should apply normal state law contractual standards to such indemnity clauses as was done in *Samuels v. Wilder,* 871 F.2d 1346 (7th Cir. 1989), and similar cases, or should they instead apply a special federal standard of narrow construction against sellers of securities whenever buyers allege federal securities claims, as was done in *Zissu v. Bear, Stearns & Co.,* 805 F.2d 79 (2d Cir. 1986), and *Layman v. Combs,* 994 F.2d 1344 (9th Cir. 1993)?

3. Whether courts should enforce stock buyers' representations and warranties that they have "received no representations or warranties from the Sellers . . . other than those contained in the [Private Placement] Memorandum"?

4. "May sophisticated, well-counselled parties, using disposable assets, dealing at their leisure and from arms' length, limit by contract what information they will consider in making a major investment?", *Layman v. Combs,* 994 F.2d 1344, 1357 (9th Cir. 1993) (Kozinski, J., dissenting).

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PETITIONERS,

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CALVIN KLEIN, GEORGE E. LAYMAN, JR., GEORGE E. LAYMAN, ZENYA YOSHIDA, DBA SHADAI FARMS, KENNETH FRANZHEIM, II, BLAS R. CASARES, EARL H. SHULTZ, RICHARD L. SCHULTZ, VIRGINIA M. McGONIGLE, JOHN F. McGONIGLE, H. JAMES GRIGGS, BARRY K. SCHWARTZ, FOREST ACRES PARTNERSHIP, a Washington State General Partnership, BARRY K. SCHWARTZ PARTNERSHIP, a New York Partnership and ROBERT D. STRATMORE,

RESPONDENTS.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

Petitioners FRANK L. BRYANT, KEMPER SECURITIES, INC. (formerly known as BATEMAN EICHLER,

HILL RICHARDS, INC.), CHARLES R. HEMBREE, and KINCAID, WILSON, SCHAEFFER & HEMBREE, P.S.C.,[1] respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit, originally filed in the above-entitled case on December 17, 1992, and amended on May 12, 1993.

REPORTS OF OPINIONS DELIVERED BELOW.

The amended opinion of the Ninth Circuit, *Layman v. Combs,* 994 F.2d 1344 (9th Cir. 1993) ("*Layman*") and the dissent of Circuit Judge Alex Kozinski are reprinted in the appendix at A-1.

The original opinion of the Ninth Circuit and the Kozinski dissent in *Layman v. Combs* were published at 981 F.2d 1093 (9th Cir. 1992). The underlying opinion and order of the United States District Court for the Northern District of California, *Stratmore v. Combs,* 723 F. Supp. 458 (N.D. Cal. 1989), are reprinted in the appendix at A-36.

The Ninth Circuit issued two other published opinions in this case: *McGonigle v. Combs,* 968 F.2d 810 (9th Cir.) (deciding the case on the merits), *cert. dismissed,* 113 S. Ct. 399 (1992) ("McGonigle"), and *Schultz v. Hembree,* 975 F.2d 572 (9th Cir. 1992) (reversing an inadequate award of attorneys' fees under Florida and Ohio fee-shifting statutes) ("Schultz").

The opinion in a related federal court case involving the same issues and the same indemnity clause but coming to a different result from the *Layman* majority, *Brownell Combs II v. Zenya Yoshida,* No. 90-131 (E.D. Ky. filed

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[1] Kemper Securities, Inc. is a subsidiary of Kemper Corp., and Kincaid, Wilson Schaeffer & Hembree, P.S.C. has no parent or subsidiary.

June 4, 1993) ("*Combs*"), is reprinted in the appendix at A-51.

STATEMENT OF JURISDICTION.

The judgment in the Court of Appeals was originally entered on December 17, 1992, and a timely petition for rehearing was denied on May 12, 1993. The Ninth Circuit filed an amended opinion on May 12, 1993. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1) (1992).

STATUTES INVOLVED.

(The text of each is set forth in the appendix.)

The Securities Act of 1933, § 11, 15 U.S.C. § 77k(e) (1993)

The Securities Exchange Act of 1934, § 29(a), 15 U.S.C. § 78cc(a) (1993).

CONCISE STATEMENT OF THE CASE.

A. Summary of the Proceeding Below

This petition emanates from the August 1983 private placement of stock in Spendthrift Farm, Inc. (the "Farm"), reputed to be the largest private placement to individuals in United States history. The litigation spawned five reported decisions, four in the Ninth Circuit, and one in the Northern District of California.[2]

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[2] As Judge Kozinski stated in his dissent in *Layman*, "Much is at stake here for everyone involved. This litigation -- although it resulted in a complete defense victory, mostly on summary judgment -- devoured a staggering quantity of productive resources. The record consists of 50 cubic feet of paper and weighs over half a ton. There were 4500 entries in the docket sheets below, including almost 400 orders and rulings by the district court. Fifty-seven briefs, consisting of nearly 1800 pages, were filed on appeal. . . ." *Layman*, 994 F.2d at 1358, App. at A-32.

The *same* indemnity clause construed by the Ninth Circuit in *Layman* was shortly thereafter interpreted differently using normal state law principles in *Brownell Combs II v. Zenya Yoshida,* No. 90-131 (E.D. Ky. filed June 4, 1993). The *Layman* majority opinion generated a strong dissent by Ninth Circuit Judge Alex Kozinski and a Harvard Law Review Comment[3] criticizing the majority's reasoning.

The Farm bred thoroughbred horses in Lexington, Kentucky. At the time of the private placement, the Farm was considered to be the "IBM" of horse breeding farms. Triple Crown winner Seattle Slew was only one of the Farm's stud horses.

This Petition relates to seven consolidated lawsuits initially brought by some of the investors in the private

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[3] Comment, *Securities Laws - Disclosure Liability - Ninth Circuit Declines to Rule on Whether Investors May Indirectly Waive Misrepresentation Claims Against Securities Issuers - Layman v. Combs, 981 F.2d 1093 (9th Cir. 1992)*, 106 Harv. L. Rev. 1697 (1993).

placement.[4] In all, fifteen plaintiffs sued fifteen defendants on over a dozen claims for relief.

The Petitioners are Frank L. Bryant (a Farm director and financial consultant), Kemper Securities, Inc. (formerly known as Bateman Eichler, Hill Richards, Inc.) (the Farm's investment banker), Charles R. Hembree (the sellers' and Farm's attorney) and Hembree's law firm. All defendants consistently denied wrongdoing and were vindicated below.[5]

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[4] Less than half the private placement investors sued. Most of the investors, two of whom were Alger B. Chapman, the former head of American Express, and Vern Winchell, the founder of Winchell's Donuts and former Chariman of the Board of Denny's Inc., never sued anybody for anything arising out of their purchases of Farm stock. The cases involved in this petition were filed in 1986-87: the *Stratmore* action, filed in February 1986; *Layman*, filed in March 1986; *Griggs*, filed in June 1986; *Yoshida*, filed in July 1986; *McGonigle*, filed in July 1986; *Schultz*, filed in August 1986; and *Casares*, filed in July 1986. These cases and several others were deemed related under the rules of the Northern District of California and assigned to the Honorable Charles A. Legge. The *Schultz* case, filed in the Southern District of Ohio, and the *Casares* case, filed in the Southern District of Florida, were transferred for pretrial purpose to the Northern District of California by the Judicial Panel on Multi-District Litigation. In October 1988, Judge Legge granted defendants' motions for change of venue to the Northern District of California in these actions. All of these cases were ultimately tried before Judge Legge.

[5] Other defendants not parties to this petition include the following: Leslie Combs II, the founder of Spendthrift and one of two sellers of stock in the private placement; Brownell Combs II, Leslie's son and also a seller in the private placement; Garth Guy, who put together the private placement on behalf of the Combses; Curtis Green and Ronald C. Ewart who allegedly helped Guy sell the offering; Richard F. Broadbent III and Bloodstock Research and Information Services, Inc., whose appraisals of the Farm's equine assets appeared in the Private Placement Memorandum; the Farm itself, which was sued in several of the cases; and Central Bank & Trust Co. of Lexington,

(continued...)

The plaintiffs sued a "stable full of defendants but lost on every claim."[6] Defendants' success on the merits, however, threatens to become only a Pyrrhic victory. As Judge Kozinski stated in his dissent,

> The case of Frank Bryant, a Spendthrift consultant, is particularly alarming. His defense was that he joined Spendthrift *after* the sale of the shares and was not in any way involved in the conception or drafting of the PPM. Defending on this theory, and winning summary judgment, Bryant was nonetheless saddled with approximately $900,000 in legal fees. If this is the face of victory, how much uglier could defeat be?

Layman, 994 F.2d at 1358 n.3, App. at A-33 (emphasis added and citation omitted).

The petitioners counterclaimed against plaintiffs based on plaintiffs' breaches of a stock subscription agreement (the "Contract"), which is reprinted in the appendix at A-71. Petitioners sought indemnification of all their expenses, including attorneys' fees.[7] Petitioner Bryant also sued for

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[5](...continued)
which lent money to various private placement investors for the purpose of purchasing the Farm's stock and was sued in a few of the cases.

[6] *Schultz v. Hembree*, 975 F.2d 572, 574 (9th Cir. 1992).

[7] In *Alyeska Pipeline Service Co. v. The Wilderness Society*, 421 U.S. 240, 247 n.18 (1975), this Court recognized that for centuries "the courts of England were authorized to award counsel fees to successful plaintiffs in litigation." It also stated the general "American rule" that "absent statute or enforceable contract, litigants pay their own attorneys' fees." *Id.* at 257. *Alyeska* refused to judicially expand fee-shifting, preferring the course of judicial restraint and deference to the voluntary (continued...)

negligent misrepresentation based upon the plaintiffs' untrue representations.

Plaintiffs moved for summary judgment on the counterclaims. The district court granted the motions and entered judgment for plaintiffs on the counterclaims. The Ninth Circuit affirmed, construing the indemnity clause against the sellers so as to avoid (what the majority termed) an "absurd" result which would have resulted from enforcing the plain meaning of the Contract. *Layman*, 994 F.2d at 1352, App. at A-18.

B. Statement of Facts

Plaintiffs were wealthy and sophisticated investors[8]

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[7](...continued)
agreements of parties and the enactments of legislators. Since *Alyeska*, Congress and State legislatures have enacted hundreds of fee-shifting statutes. *See* Richard Larson, *Federal Court Awards of Attorneys' Fees* (1981), and California Continuing Education of the Bar, *California Attorneys' Fees Award Practice* (1982). Parties, of course, have entered into thousands of voluntary fee-shifting agreements as *Alyeska* authorized them to do.

[8] Each investor represented that he had a net worth of five million dollars at the time of the private offering, but several of them including Calvin Klein, Kenneth Franzheim and Zenya Yoshida were reputed to be worth over fifty million each. Plaintiffs gained their wealth and sophistication in a variety of contexts. Plaintiff Calvin Klein and his lifelong business partner Barry Schwartz made millions in jeans and perfume before going into the thoroughbred horse business and they hired a CPA with a masters in taxation from New York University law school to evaluate the private offering for them. Blas Casares was on the Central Intelligence Agency payroll in a top secret mission in Cuba at the time of the Bay of Pigs and made his millions in commodities trading in South America. Plaintiff Franzheim made a fortune in oil and gas before being appointed United States Ambassador to New Zealand. Plaintiff Schultz made tens of millions building one of the nation's

(continued...)

who alleged that the defendants misled them into buying Farm stock. Some plaintiffs bought over $2,200,000 of stock and their average investment was over $1,000,000 per plaintiff. The plaintiffs included:

1. Calvin Klein, New York
2. George E. Layman, Jr., Washington State
3. Zenya Yoshida, dba Shadai Farms, Japan
4. Kenneth Franzheim, II, Texas and Kentucky
5. Blas R. Casares, Florida and Venezuela
6. Earl H. Shultz, California
7. Richard L. Schultz, Ohio
8. Virginia M. McGonigle, California
9. John F. McGonigle, California
10. H. James Griggs, California
11. George E. Layman, Washington State
12. Barry K. Schwartz, New York
13. Forest Acres Partnership, a Washington State general partnership
14. Barry K. Schwartz Partnership, a New York general partnership
15. Robert D. Stratmore, California

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[8](...continued)
largest debt collection agencies. Plaintiff Griggs was financial advisor to the pension plan of California's state employees. Plaintiff Stratmore was an associate at Pillsbury, Madison & Sutro, one of California's largest law firms before he was suspended from the practice of law by the California Supreme Court for defrauding 11 New York law firms in *Stratmore v. State Bar of California,* 14 Cal. 3d 887, 123 Cal. Rptr. 101, 538 P.2d 229 (1975).

The plaintiffs had substantial experience with horse breeding. Most retained independent investment advisors and lawyers and took their time considering the investment. "Typical is Robert Stratmore, an attorney who specialized in equestrian law and transactions, who grossed more than $15 million in thoroughbred trading the year of the Spendthrift offering and who holds lifetime breeding rights to Triple Crown winner Seattle Slew." *Layman*, (Kozinski dissent), 994 F.2d at 1356 n.1, App. at A-28. Other plaintiffs "included international fashion mogul Calvin Klein; Zenya Yoshida, Japan's biggest and most prominent horse breeder; and the Layman family, who has been involved with thoroughbred horses for thirty years." *Id.*, App. at A-29. Obviously, "[t]hese weren't mom and pop investors. . . ." *Id.* at 1356, App. at A-28.[9]

The plaintiffs bought stock from Leslie Combs and Brownell Combs (the "sellers") in the sellers' 1983 private placement of Farm stock. In connection with the purchase each plaintiff executed a Contract which promised:

> to indemnify [defendants] against any losses, claims, damages, liabilities, *expenses (including attorneys' reasonable fees* and disbursements) judgements and amounts paid in settlement *resulting from the untruth* of any of the warranties and representations contained herein, or the breach . . . of the covenants made by him herein.

---

[9] Judge Kozinski noted these facts when he wrote in exasperation, "Under these circumstances, what on earth does it mean to say the subscribers didn't have notice of the attorneys' fee indemnity clause? . . . If these subscribers can't be held to the terms of the contract they signed, who ever can? *Id.* at 1357, App. at A-29, A-30.

Contract, para. 5, App. at A-78 (emphasis added).

Each Contract contained a warranty and representation that the buyer had read the Private Placement Memorandum ("PPM") and that the buyer was not relying on any representations other than those in the PPM.

Three years later, after a dramatic downturn in the market for thoroughbred horses, the plaintiffs brought suit against the defendants for common law tort claims and violation of several state statutes, federal RICO, and federal securities laws, including failure to register a public offering (alleging that the sellers' so-called "private offering" of Farm stock was in reality a "public offering").[10] The defendants included the private placement's two sellers, the lawyers for the sellers and the Farm, the sellers' horse appraisers, the private placement promoter, one of the Farm's directors, the Farm's investment banking firm, the Farm's commercial bank, and the Farm's outside accountants.

As the *Layman* panel stated in its related opinion, *Schultz v. Hembree,* 975 F.2d 572, 576 (9th Cir. 1992):

> We live in a society which, unfortunately, sanctions the view that litigation is a proper response to many of life's hard knocks. Lawyers capitalizing on this phenomenon often multiply unnecessarily the number of legal theories under which suit is brought. The result in many cases is shotgun litigation: a barrage of claims, emanating

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[10] Marc H. Morgenstern, *Private Placement Guidelines -- A Lawyer's Letter to a First-time Issuer,* 48 The Bus. Law. 257 (1992), summarizes current federal securities law governing private placements.

from a point source and fanning out in the hopes of wounding someone in the process.

Plaintiffs made numerous allegations concerning the private placement which left no doubt that their own representations and warranties were false. The following examples are illustrative:

What Plaintiffs Said In Their Contract

1. Plaintiffs *received no representations* from the sellers other than those in the PPM. (¶4(n).)

2. Plaintiffs *understood* that the financial information in the PPM is "unaudited" and "no provision has been made for deferred taxes." (¶4(v).).

3. Plaintiffs *understood* that there were restrictions on the transferability of the stock, that there will be no market for the shares, and it may not be possible to liquidate the investment. (¶4(h).)

What Plaintiffs Said In Their Complaints[11]

1. Plaintiffs relied on numerous untrue *oral* representations. (¶¶40, 51.)

2. Plaintiffs were *misled* because the financial information in the PPM failed to conform to generally accepted accounting principles and made no provision for deferred taxes. (¶36(a)(v).)

3. Plaintiffs were induced to purchase stock by *oral misrepresentations* that they would have an opportunity to "cash out" of the deal. (¶50.)

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[11] All paragraph references are to the First Amended Complaint in the *Layman* action, which served as a model for the other plaintiffs' complaints.

Plaintiffs freely admitted at trial that their representations and warranties were untrue. For example, as to their reliance on oral representations:

* Plaintiff Calvin Klein's CPA financial advisor and tax lawyer, Ralph Finerman, testified that he relied upon oral representations made by defendants Guy and Hembree.

* Plaintiff Layman testified that he relied on oral representations made by defendants Hembree and Guy.

* Plaintiff Schultz testified that he relied upon oral representations by Luther Deaton of Central Bank.

* Plaintiff Griggs testified that he relied upon oral representations made by defendant Guy.

* Plaintiff Casares testified that he relied heavily on oral representations made to him by defendant Hembree.

Moreover, as is often true in high-stakes litigation, defendants incurred large expenses. Defendants incurred millions of dollars in attorneys' fees in successfully defending these suits.[12] Through their counterclaims, defendants

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[12] Judge Kozinski's dissent noted that "[t]he attorneys' fees, for the seven defendants who requested them, amounted to more than $3.5 *million*." *Layman*, 994 F.2d at 1358, App. at A-32 (emphasis in original). Attorneys' fees were not, however, the only losses suffered: Bryant alleged in his counterclaim that he suffered emotional distress and loss of reputation as a result of plaintiffs' untrue representations and warranties.

sought reimbursement for the losses they incurred by reason of the untruth of plaintiffs' representations and warranties.

REASONS FOR GRANTING THE WRIT

I.

THE CIRCUIT COURTS CONFLICT IN CONSTRUING INDEMNITY CONTRACTS BY BUYERS OF SECURITIES AS TO WHETHER TO (A) APPLY TRADITIONAL STATE LAW CONTRACTUAL INTERPRETATION PRINCIPLES, OR (B) CREATE A FEDERAL RULE OF NARROW CONSTRUCTION AGAINST SELLERS OF SECURITIES.

The prime reason certiorari is appropriate in this case is the conflict between certain recent circuit court decisions which "federalize" indemnity contract interpretation in stock fraud cases and the majority of federal cases which apply state law to decide the plain meaning of such contracts.

Federal cases are split in their approach to indemnity provisions agreed to by buyers. The only "trend" surfacing, however, is confusion. A new line of federal cases, while acknowledging that indemnity provisions are generally enforceable have refused to enforce them for want of specificity.

A. The Majority of Federal Cases Apply Traditional State Law Contract Interpretation Rules.

Most federal courts apply traditional rules of contract interpretation to indemnity clauses contained in stock purchase agreements. In contrast, a seminal recent case, *Zissu v. Bear, Stearns & Co.*, 805 F.2d 75 (2d Cir.

1986), consciously refused to apply state law contractual interpretation principles to indemnity contracts in securities cases. *Layman* followed *Zissu* in creating a new federal rule to apply against stock sellers in indemnity cases.

The traditional rule is best illustrated by *Samuels v. Wilder,* 871 F.2d 1346 (7th Cir. 1989).

Samuels enforced a counterclaim for indemnity in a securities fraud case. *Samuels* applied traditional contract law principles to give meaning to the indemnity clause. The indemnity clause obligated the buyer of stock to "hold [seller] harmless from all liability, loss, expenses, damages, costs and attorneys' fees that [seller] may at any time incur by reason of any type of inquiry, action or suit which may be brought against him . . . by reason of the [relationship]." *Samuels v. Wilder,* 871 F.2d at 1348. The court noted that the sophisticated securities purchaser "should have insisted upon other language" if he had "any reservations about the scope of the indemnity clause." *Id.* at 1352. The Seventh Circuit squarely faced the public policy concerns which troubled the majority in *Layman*:

> Public policy does not intervene as plaintiffs assert. This is not a loss created by [defendant] that plaintiffs are forced to pay. Rather, the loss (litigation expenses) resulted from a successful defense of a suit brought by plaintiffs."

Id. at 1352.

Another example of the traditional rule is *Tartell v. Chelsea Nat'l. Bank*, 470 F.2d 994 (2d Cir. 1972), in which the Second Circuit essentially adopted the opinion below, *Tartell v. Chelsea Nat'l Bank,* 351 F. Supp. 1071 (S.D.N.Y. 1972), which held that a bank could collect attorneys' fees under a clause which stated: "The undersigned (Tartell) will

pay to the Bank all expenses (including expenses for legal services of every kind) . . . incidental to the enforcement of any of the provisions hereof . . . ." *Id.* at 1079. The opinion adopted by the Second Circuit specifically recognized that "[t]he federal statutes underpinning plaintiff's claims in this case do not specifically provide for counsel fees; indeed, the usual rule is that in the absence of statutory authority or an authorizing contract, federal courts do not award counsel fees." *Id.* The opinion also rejected the argument that the unsuccessful plaintiff should "not be unfairly penalized for asserting claims, as was his right, under the applicable federal statutes," since the "broad language of the demand note in question" was something of which the plaintiff must have been aware. *Id.*

Both *Samuels* and *Tartell* applied standard state law contractual interpretation principles to the indemnity provisions at issue. *Zissu* distinguished *Tartell* on the grounds that the *Tartell* indemnity clause mentioned legal expenses.

Layman conflicts with *Samuels* and *Tartell* and goes beyond *Zissu* because *Layman* required an explicit statement that "if the investor breaches a warranty in suing the sellers, and loses, then the investor must pay the defendants' fees." *Layman*, 994 F.2d at 1352, App. at A-17, A-18. In dissent, Judge Kozinski stated that his colleagues in the majority refused to enforce the contract "under the guise of interpretation" when their true motivation was that they found the Contract unpalatable. *Id.* at 1354, App. at A-24. According to Judge Kozinski, "The clause in question says precisely what the sellers claim: It entitles them to attorney's fees for litigation arising out of misrepresentations by the subscribers as to what they did and did not rely on." *Id.* at 1354-55, App. at A-24.

Layman also conflicts with two recent Ninth Circuit decisions. It conflicts with *Atari Corp. v. Ernst & Whinney*, 981 F.2d 1025 (9th Cir. 1992), because *Atari* was a stock fraud case which enforced an indemnity clause which was less specific than the indemnity clause in *Layman*. In *Atari*, the counterclaim was based upon an indemnity claim which merely said "[Atari] will indemnify all present and former officers and directors of the company to the fullest extent permitted by applicable law with respect to all acts and omissions arising out of such individuals' services as officers, directors or employees of the company. . . ." *Id.* at 1031.

Ironically, in its opinion on the merits in this case, *McGonigle v. Combs*, 968 F.2d 810, 827 (9th Cir.), *cert. dismissed*, 113 S. Ct. 399 (1992), this same panel unanimously affirmed the district court's award of over $200,000 in attorneys' fees to defendant Central Bank under an indemnity clause no more specific than the indemnity clause in the Contract. *Id.* at 827 n.22. The Central Bank counterclaim was based on a promissory note which provided that "The Maker will pay on demand all costs of collection and attorneys' fees incurred or paid by the Holder in enforcing this note on default."

Lower federal court cases applying traditional state law rules to indemnity contracts in stock fraud contexts include *Barnebey v. E.F. Hutton & Co.*, 715 F. Supp. 1572 (M.D. Fla. 1989). In *Barnebey*, the court held an indemnity clause similar to that in the Farm Contract could be enforced because it did not violate public policy. The court denied summary judgment and sent the case to the jury.

B. *Zissu* and *Layman* Create A Federal Rule Of Narrow Construction Against the Sellers of Securities Whenever Stock Fraud Is Alleged.

Zissu v. Bear, Stearns & Co., 805 F.2d 75 (2d Cir. 1986), *Layman*, and their progeny have sought to create a federal rule of narrow construction in interpreting indemnity provisions. These courts have rejected traditional state law interpretation of indemnity agreements and are in the process of "federalizing" a new standard of interpretation. *Zissu* was explicit about departing from established state law:

> although New York courts have held that contractual indemnity provisions for attorneys' fees will be enforced, and broad indemnification provisions like the one here should be read to extend to such fees, a higher level of specificity is required when attorneys' fees are being assessed against a plaintiff suing for securities fraud.

Id. at 79-80 (citations omitted).

Zissu did not specify what it meant by "a higher level of specificity," although it hinted that the indemnity it dealt with should have specifically included the words "attorneys' fees." The *Layman* majority, applying *Zissu*, found an indemnity clause insufficient as a matter of law even though it did specifically include the words "attorneys' fees."

Layman held that even more specificity is required. As Judge Kozinski stated:

> Here we have just such a higher level of specificity [as *Zissu* required]: Every subscriber agreed to indemnify the sellers

> "from and against any losses, claims, damages, liabilities, *[and] expenses (including attorneys' reasonable fees and disbursements)* . . . resulting from the untruth of any of the warranties" (emphasis added). The lack of notice that troubled the Second Circuit in *Zissu* just isn't a problem here.

Layman, 994 F.2d at 1356, App. at A-28 (emphasis added by Judge Kozinski).

II.

The Federal Rule of Narrow Construction Against the Sellers of Securities Conflicts With State Law Enforcing The Plain Meaning Of Indemnity Contracts.

The federal narrow construction rule now emerging conflicts with well settled state law rules of contractual interpretation. The local law of the state which has the most significant relationship to the transaction applies to questions of contractual interpretation absent an effective choice of law by the parties. *Commercial Ins. Co. of Newark, New Jersey v. Pacific-Peru Constr. Corp.*, 558 F.2d 948 (9th Cir. 1977). Cases specifically addressing indemnity clauses have applied the law of the state in which the contract was entered into. *Hill v. Chrysler Corp.*, 526 F.2d 350 (5th Cir. 1976); *see also Klaxon Co. v. Stentor Elec. Mfg. Co.*, 313 U.S. 487 (1941) (holding that in interpreting a contract, a court should apply the law of the state in which the parties entered into the contract).

The *Samuels*, *Tartell*, *Atari* and *McGonigle* cases enforcing the plain meaning of broadly worded attorneys' fees and indemnity clauses are in the main stream of contractual interpretation. "It is axiomatic that absent a violation of public policy, a statute, or a constitutional

provision, the parties to a private agreement may allocate risks in any manner they so choose." *Reserve Ins. Co. v. Pisciotta*, 30 Cal. 3d 800, 814, 180 Cal. Rptr. 628, 636, 640 P.2d 764 (1982); *Hendrix v. Fireman's Fund Ins. Co.*, 823 S.W.2d 937, 941 (Ky. Ct. App. 1991) ("The parties to a private agreement may allocate risks in any manner they choose, absent a violation of law."); *Perpetual Real Estate Servs., Inc. v. Michaelson Properties, Inc.*, 974 F.2d 545, 550 (4th Cir. 1992) ("Absent some evidence of misrepresentation, 'courts should not rewrite contracts or disturb the allocation of risk the parties have themselves established'.").[13]

"[E]xpress indemnity rests on the contract of the parties; it is the language of contract, rather than the equities of the situation which govern. In an express indemnity agreement, the parties may agree to results which would not occur in absence of an express agreement. . . ." *Smoketree - Lake Murray, Ltd. v. Mills Concrete Constr. Co.*, 234 Cal. App. 3d 1724, 1737, 286 Cal. Rptr. 435, 452 (1991); *United Food & Commercial Workers Union v. Lucky Stores, Inc.*, 806 F.2d 1385, 1386 (9th Cir. 1986) ("Wise or not, a deal is a deal.").

Judge Kozinski, in his dissent in *Layman*, noted that the majority's summary judgment ruling conflicts with the highest court of the state of California: "California law is

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[13] The plain meaning rule is rooted in common sense and judicial restraint. *See* Frederick Schauer, *Statutory Construction and The Coordination Function of Plain Meaning*, 1990 Supreme Court Review 231, 232 (1991) ("[Supreme Court Justices] know that when they ask a law clerk for a tuna fish sandwich and the briefs in *Roe v. Wade*, what they get is a tuna fish sandwich and the briefs in *Roe v. Wade*."); *Pavelic & LeFore v. Marvel Entertainment Group*, 493 U.S. 120, 126 (1989) ("Our task is to apply the text, not to improve on it.").

just the opposite. If the language of a contract is susceptible to two different meanings, each side is entitled to put in evidence supporting its preferred construction. *See, e.g., Pacific Gas & Elec. Co. v. G.W. Thomas Drainage & Rigging Co.*, 69 Cal. 2d 33, 37, 69 Cal. Rptr. 561, 442 P.2d 641 (1968). Even if the language seems susceptible to only one meaning, a party may still put on evidence that a second meaning reflects the parties' actual intent. *Id.* at 39-40." *Layman*, 994 F.2d at 1355, App. at A-25, A-26. California's position on the issue is illustrated by *Finalco, Inc. v. Roosevelt*, 235 Cal. App. 3d 1301, 1306, 3 Cal. Rptr. 2d 865, 867 (1991), which enforced an indemnity clause obligating a buyer of stock "to pay all costs of collection, . . . including . . . attorneys' fees" incurred in successfully defending against federal securities law claims arising out of a private placement.[14]

Similarly, under Kentucky law the right to recover under indemnity contracts is also well recognized. "[Indemnity] contracts are not against public policy and will be enforced if the indemnitee has suffered loss." *United States Fidelity & Guar. Co. v. Napier Elec.*, 571 S.W.2d 644, 646 (Ky. App. 1978).

In *Brownell Combs II v. Zenya Yoshida*, No. 90-131 (E.D. Ky. filed June 4, 1993), the Kentucky district court

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[14] The State Bar of California even uses such agreements in a form book and computer diskette of forms which it makes available to California lawyers. Ellen L. Batzel, California Continuing Education of the Bar, *Advising California Partnerships* § 5.38 at 58-59 (2d ed., Supp. 1993) ("the undersigned [has] relied only on the information contained in the Memorandum. . . . The undersigned agrees to indemnify [the sellers] against any . . . expense . . . arising out of: (i) any inaccuracy in the undersigned's . . . representations and warranties. . . ")

construed the same indemnity contract as the Ninth Circuit did in *Layman*. *Combs* applied Kentucky law because the Contract was entered into in Kentucky. *Combs* noted "Kentucky's well recognized policy of upholding the right of recovery under indemnity contracts. . . ." *Id.* at 7, App. at A-58. The court went on to state that "the *plain language* of the indemnity clause does not limit indemnification to the situation where the registration exemption is lost. . . . " *Id*, App. at A-58. (emphasis added).

This Court has upheld a wide variety of contracts against claims that federal policies counseled against enforcement. *See, e.g., Shearson/American Express, Inc. v. McMahon,* 482 U.S. 220 (1987) (enforcing agreement to arbitrate securities claims despite the historical judicial hostility toward such contracts); *Carnival Cruise Lines, Inc. v. Shute,* 111 S.Ct. 1522 (1991) (enforcing forum selection clause contained in cruise line's passenger's ticket).

The *Layman* and *Zissu* rule of narrow construction, in contrast, is an activist rule creating a federal preemption which ignores the deference our system of federalism gives to the states on issues of contractual interpretation.

III.

The Federal Rule of Narrow Construction Against Sellers of Securities Leads to Unfair, Inconsistent, Anomalous and Extreme Results.

A. Unfair Favoritism of Stock Buyers Over Stock Sellers.

The *Layman* decision tips the scales of contractual interpretation in favor of stock buyers and against stock sellers. Ironically, Rule 10b-5 was promulgated in order to equalize the remedies between defrauded sellers and buyers

of securities. *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 736 (1975), stated that "Rule 10b-5 was adopted in order to close 'a loophole in the protections against fraud . . . by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase.'"

By immunizing stock buyers against liability for their untrue representations, *Layman* and *Zissu* turn Rule 10b-5 on its head.

In this case the *Layman* and *Zissu* rule also upset the delicate bargain struck between the sellers and the plaintiffs who paid only $7.50 per share for their Farm stock and gave written representations and warranties. Only three months later, the sellers sold Farm stock to the public at $12 per share but received no representations and warranties. *McGonigle v. Combs,* 968 F.2d 810, 815 (9th Cir.), *cert. dismissed*, 113 S. Ct. 399 (1992). The private placement buyers' representations, warranties and indemnity promises were clearly worth a portion of the $4.50 per share differential to the sellers. The effect of the *Layman* and *Zissu* line of cases is to nullify a portion of the bargained-for consideration negotiated by sellers in private placements.

B. Inconsistent Results in the Same Case.

Inconsistent results are no better illustrated than by the fact that two different district courts have reached diametrically different results about the same indemnity clause in the same Contract, about attorneys' fees in the same private offering litigation. In *Brownell Combs II v. Zenya Yoshida,* No. 90-131 (E.D. Ky. filed June 4, 1993), the Eastern District of Kentucky construed the same indemnity provision in the same Contract as the instant

case. On summary judgment, *Combs* refused to follow *Layman*'s narrow construction against sellers in interpreting the Contract. Instead, *Combs* held that the Kentucky jury[15] was entitled to decide the plain meaning of the Contract.

Combs rejected both the arguments raised by plaintiffs in *Layman*, namely, that the indemnity should be limited solely to untrue representations that result in loss of the private placement exemption, and that the Securities Act of 1933, § 11, 15 U.S.C. § 77k(e) (1993), provides the sole mechanism for obtaining attorneys' fees in a stock fraud suit. *Combs*, slip op. at 5, App. at A-55, A-56, A-57.

With respect to plaintiffs' arguments as to the Securities Act of 1933, § 11, 15 U.S.C. § 77k(e) (1993), *Combs* refused to read new words into the statute:

> Nowhere in § 77k(e) does the word *only* appear, and this Court will not add the word *only* by judicial fiat. Absent any explicit statutory language or any supportive case law . . . , the Court cannot conclude that

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[15] One of the sellers, Brownell Combs, was denied leave to file his counterclaim in the Northern District of California, so he took his case to Kentucky. By virtue of the fact that Mr. Combs brought his action in Kentucky, he is now going to trial. In their monumental study of this Court's certiorari practices, Samuel Estreicher & John E. Sexton, *A Managerial Theory of the Supreme Court's Responsibilities: An Empirical Study*, 59 N.Y.U. L. Rev. 681, 725 (1984), concluded that "an intolerable conflict occurs when litigants are able to exploit conflicts affirmatively through forum shopping, or when the planning of primary behavior is thwarted by the absence of a nationally binding rule." Private placements offer great opportunity for forum shopping because investors and potential defendants often reside in different states and offerings are permitted to cross state borders. Advance planning becomes pointless when there is an existing conflict between a half-dozen circuit court decisions.

> assessment of costs is only proper upon a finding that the defendant's prior claims lacked merit.

Combs, slip op. at 5, App. at A-55, A-56 (emphasis added).

In rejecting plaintiffs' narrow interpretation of the indemnity clause, *Combs* stated:

> This Court has reviewed the record and the documents under dispute and cannot find as a matter of law that the indemnification clause is limited to situations where Spendthrift looses [sic] its registration exemption.

Combs, slip op. at 6, 7, App. at A-57.

Combs alluded to the uncertainty prevailing in federal courts as to indemnity in stock fraud cases: "other jurisdictions are split as to their conclusions regarding the enforceability of the indemnity clauses, and it cannot be said that any clear majority rule exists . . . ." *Combs*, slip op. at 7, App. at A-57.

C. Anomalous Results.

A federal rule of narrow construction against sellers of securities leads to anomalous results, such as the *Layman* majority terming irrational those who would interpret an indemnity clause according to its plain meaning, a class which includes all the petitioners here, Judge Kozinski, the Eastern District of Kentucky, and the Harvard Law Review.[16] Judge Kozinski noted in his *Layman* dissent that:

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[16] Comment, *Securities Laws - Disclosure Liability - Ninth Circuit Declines to Rule on Whether Investors May Indirectly Waive* (continued...)

"The majority thus holds that a trier of fact would have to be *drunk or crazy to construe the contract to mean what it says.*" *Layman*, 994 F.2d at 1355, App. at A-25 (emphasis added). Judge Kozinski further observed that: "[The majority twists] the law of contract beyond recognition," and "categorically reject[s] the plain language of the contract." *Id.*, App. at A-24, A-26. "I'd just read the disputed language as written." *Id.* at 1356, App. at A-27.

D. Extreme Results.

The increasing hostility with which some federal courts treat indemnity clause in stock fraud cases is reflected in *In re Integrated Resources Real Estate Ltd. Partnership Securities Litigation,* 815 F. Supp. 620 (S.D.N.Y. 1993). There, the district court considered a broad indemnity provision promising that the stock buyers would:

> indemnify the defendants for any and all expense, *including costs and reasonable attorneys' fees* . . . in connection with any of his warranties or his failure to fulfill any of his covenants or agreements under this agreement. . . .

Id. at 657 (emphasis added).

Despite the specific language in this indemnity clause, *Integrated Resources* followed the *Layman* and

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[16](...continued)
Misrepresentation Claims Against Securities Issuers - Layman v. Combs, 981 F.2d 1093 (9th Cir. 1992), 106 Harv. L. Rev. 1697 (1993), criticized *Layman*'s narrow interpretation of the Contract. The author instead endorsed Judge Kozinski's reading of the plain meaning of the Contract, stating: "Judge Kozinski properly rejected the majority's interpretation of Spendthrift's Agreement." *Id.* at 1700.

Zissu line of cases and held that the indemnity clause was not sufficient to put the investors on notice. No hint was found within the four corners of the opinion as to what further notice could ever be deemed sufficient.

Zissu, *Layman* and *Integrated Resources* have required an ever increasing specific threshold for enforcement of indemnity clauses. None of these decisions points out what more is actually required. The only hint given in *Zissu* was that indemnity clauses should clearly refer to "attorneys' fees." However, in *Layman* and *Integrated Resources* even the specific recitation of "attorneys' fees" in the indemnity clause proved insufficient. Stock sellers are left to wonder how much more specific such an indemnity clause must be.

IV.

A Clear Federal Rule Enforcing Indemnity Contracts By Stock Buyers Would Promote The Efficient Operation Of The Nation's Capital Markets.

An unambiguous federal rule enforcing indemnity clauses in stock purchase agreements would have a salutary effect upon the nation's capital markets. Judge Kozinski termed the indemnity clause in question a "perfectly acceptable and useful provision in a private placement agreement." *Layman*, 994 F.2d at 1357, App. at A-30. The majority termed enforcing or agreeing to such a provision as "absurd." *Id.* at 1352, App. at A-18. This dispute is, according to Judge Kozinski, "the meat of the coconut -- the difficult policy question at the heart of this dispute." *Id.* at 1357, App. at A-30.

The enforceability and construction of indemnity clauses have taken on increased significance in this age of

hugely expensive "strike suits."[17] Scholars have addressed the importance and the use of indemnity clauses in private placements,[18] while a recent article in The New York Times[19] discussed proposed legislation aimed at protecting sellers of stock from meritless securities fraud suits.

The popular press has expressed alarm at the burden modern litigation places on parties and society. Walter K. Olson, *The Litigation Explosion - What Happened When America Unleashed the Lawsuit* 337 (1991) ("Full two-way fee-shifting is the single most important and constructive legal reform that ordinary citizens can fight for over the long term. It is memorably simple, and fair, and not easily subverted once put into effect.")

These criticisms and suggested remedies are not limited to the popular press, but have gained support from legal scholars and judges. Robert Bork stated that *The Litigation Explosion* "correctly analyzed the sickness of our litigation system" and provided "prescriptions for at least a partial cure that are worth trying." Robert Bork, *Litigation*

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[17] Janet C. Alexander, *Do The Merits Matter? A Study of Settlements in Securities Class Action*, 43 Stan. L. Rev. 497, 513 (1991) ("[The data] strongly suggest that suits alleging securities violations were filed whenever the stock price declined sufficiently following the IPO to support an award of attorneys' fees that would make it worthwhile to bring a case.").

[18] Henry Klehm III, Comment, *Contractual Shifting of Defense Costs in Private Placement Offering Securities Litigation*, 36 U. Pa. L. Rev. 971 (1988).

[19] Susan Antilla, *A Battle Over Securities Fraud Cases*, The New York Times, July 4, 1993, Section "D" at 14.

Explodes With Well-Told Tale of Unleashing the Lawsuit, Washington Times, April 29, 1991, at F1.

As Judge Kozinski points out in his dissent, we may assume "that our national interest is served when financial markets function efficiently, unbeclouded by the risk of kamikaze litigation." *Layman*, 994 F.2d at 1358, App. at A-33. By limiting the circumstances in which indemnification provisions may be enforceable, the *Zissu* and *Layman* courts necessarily affect the operation of those markets. Like Judge Kozinski, petitioners believe that "a clear statement that [federal courts] *will* enforce a subscriber's warranty he hasn't considered matters outside the offering materials would have an entirely salutary effect [on the efficient operation of the nation's financial markets.]" *Id.* at 1358, App. at A-33, A-34 (emphasis in original).

Enforcing indemnity provisions allows courts to control litigation abuses. As Judge Kozinski documents in his dissent, the litigation the plaintiffs instituted consumed "a staggering quantity of productive resources." *Id.* at 1358, App. at A-32. Millions of dollars were spent defending claims which were judged to be without merit. The amount of judicial resources expended was equally alarming. These costs were directly attributable to the plaintiffs' untrue representations. If the provisions of the Contract -- and contracts like it -- are not given effect, one would expect to see those same litigation techniques employed again by other investors. Shifting the costs where they belong -- to parties who have agreed to accept them -- will enable courts to strike a blow against abusive litigation without engaging in judicial activism.

Moreover, indemnification provisions in subscription agreements enable sellers to limit and control the informa-

tion provided to investors. Documents such as the Farm's PPM are carefully drafted and reviewed for accuracy and legal sufficiency. The purpose of this process is to provide accurate information to prospective investors. This goal is thwarted if investors disregard the offering materials and base their decisions on other purported information -- which may not be subject to the same scrutiny and controls as the written offering materials.

Enforcement of indemnification contracts will have the beneficial effect of allowing sellers and others to rely upon the information provided to them by investors. Put another way:

> The purpose of the contractual indemnification provision is to hold a wealthy and sophisticated investor to her warranties and to insure that she has read and understands, the precise disclosures with which the law requires she be provided. To hold that such a provision is "contrary to the Act" makes disclosure the futile and expensive exercise many fear. After all, who is better situated to understand the mandated disclosure than the knowledgeable and experienced investor?

Henry Klehm III, Comment, *Contractual Shifting of Defense Costs in Private Placement Offering Securities Litigation,* 36 U. Pa. L. Rev. 971, 988 (1988).

CONCLUSION

For these reasons and those stated in Judge Kozinski's dissent, Petitioners urge this Court to grant a writ of certiorari. Doing so will resolve a festering conflict

among the circuits, prevent forum shopping, and inject needed clarity and certainty into federal law.

Dated: August 9, 1993

Respectfully submitted,

THOMAS K. BOURKE*
DAVID L. ARONOFF
Turken, Melman & Bourke

Attorneys for Petitioner Frank L. Bryant

***Counsel of Record**

JAMES E. BURNS, JR.
JOHN MISSING
KEVIN P. MUCK
Brobeck, Phleger & Harrison

Attorneys for Petitioner Kemper Securities, Inc. (formerly known as Bateman Eichler, Hill Richards, Inc.)

M. LAURENCE POPOFSKY
MICHAEL L. RUGEN
RICHARD DeNATALE
Heller, Ehrman, White & McAuliffe

Attorneys for Petitioners Charles R. Hembree and Kincaid, Wilson, Schaeffer & Hembree, P.S.C.

No. _____

In the Supreme Court of the United States

October Term, 1993

FRANK L. BRYANT, KEMPER SECURITIES, INC., a Delaware Corporation (formerly known as BATEMAN EICHLER, HILL RICHARDS, INC.), CHARLES R. HEMBREE, and KINCAID, WILSON, SCHAEFFER & HEMBREE, P.S.C., a Kentucky Corporation,

PETITIONERS,

v.

CALVIN KLEIN, GEORGE E. LAYMAN, JR., GEORGE E. LAYMAN, ZENYA YOSHIDA, DBA SHADAI FARMS, KENNETH FRANZHEIM, II, BLAS R. CASARES, EARL H. SHULTZ, RICHARD L. SCHULTZ, VIRGINIA M. McGONIGLE, JOHN F. McGONIGLE, H. JAMES GRIGGS, BARRY K. SCHWARTZ, FOREST ACRES PARTNERSHIP, a Washington State General Partnership, BARRY K. SCHWARTZ PARTNERSHIP, a New York Partnership and ROBERT D. STRATMORE,

RESPONDENTS.

PROOF OF SERVICE BY MAIL

State of California

ss.

County of Los Angeles

I, the undersigned, say: I am and was at all times herein mentioned, a citizen of the United States and a

resident of the County of Los Angeles, over the age of eighteen (18) years and not a party to the within action or proceeding; that my business address is 9105 Sunset Boulevard, West Hollywood, California 90069; that on August 9, 1993, I served the within *Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit* in said action or proceeding on all parties required to be served by depositing true copies thereof, enclosed in sealed envelopes with first-class postage thereon fully prepaid, in the United States mail at Los Angeles, California, addressed as follows:

Clerk, United States Supreme Court
One First Street, N.E.
Washington, D.C. 20543
(By Express Mail: Original and Forty Copies)

Clerk, United States Court of Appeals
Ninth Judicial Circuit
121 Spear Street
San Francisco, California 94119-3939
(Three Copies)

John I. Alioto, Esq.
Alioto & Alioto
505 Montgomery St., 10th Floor
San Francisco, California 94111
Counsel for Calvin Klein, George E. Layman, Jr., George E. Layman, Kenneth Franzheim, II, Earl H. Shultz, Richard L. Schultz, Virginia M. McGonigle, John F. McGonigle, H. James Griggs, Barry K. Schwartz, Forest Acres Partnership, Barry K. Schwartz Partnership, and Robert D. Stratmore
(Three Copies)

Richard M. Trautwein, Esq.
Alagia, Day & Mintmeir
325 W. Main Street
2000 Waterfront Plaza
Louisville, Kentucky 40202
Counsel for Blas R. Casares
(Three Copies)

Michael J. Bettinger, Esq.
Pillsbury, Madison & Sutro
P.O. Box 7880
San Francisco, California 94120-7880
Counsel for Zenya Yoshida, dba
Counsel for Zenya Yoshida, dba
(Three Copies)

I declare under penalty of perjury that the foregoing is true and correct. Executed on August 9, 1993, at Los Angeles, California.

Betty J. Malloy
(Original Signed)